Credit Booms, Banking Crises, and the Current Account

Scott Davis
Hong Kong Institute for Monetary Research
Federal Reserve Bank of Dallas

Adrienne Mack
Federal Reserve Bank of Dallas

Wesley Phoa
The Capital Group Companies

Anne Vandenabeele
The Capital Group Companies

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Summary

Recent research has shown that a period of rapid credit growth is a robust predictor of future banking crises. At the same time the experience of a number of countries during the recent Global Financial Crisis highlights the fact that rapid credit growth fueled by external borrowing is a recipe for a banking or financial crisis. This same combination of credit growth and external deficits was at work during the East Asian crisis in the late 1990's and the Latin American crises of the 1980's.

With these episodes in mind, many authors have discussed how capital inflow "bonanzas" can lead to a rapid expansion of credit which can then lead to a banking crisis. This raises an interesting question: is credit growth itself the cause of a crisis, or is it the combination of credit growth and external deficits? In other words, does the source of credit matter?

To answer this question, this paper estimates the marginal effect of private sector credit growth on the probability of a banking crisis and estimates whether this marginal effect is itself a function of the current account. If a country is experiencing high credit growth and a current account deficit, that credit growth is being fueled from foreign borrowing. When a country is experiencing credit growth and a current account surplus, that credit growth is being fueled from domestic savings. If the marginal effect of credit growth on the probability of a crisis is not a function of the current account, then high credit growth alone is a strong predictor of a crisis. If however this marginal effect is a function of the current account and is higher when the current account is in deficit, then it is the combination of high credit growth with foreign borrowing that is a predictor of a crisis.

In a panel data framework, we include variables like the growth in private sector credit and the current account in either a logit or a linear probability model to find the effect these variables on the probability of a banking crisis. We find that the marginal effect depends strongly on the current account. For a country with a balanced current account, a 1 percentage point increase in credit growth increases the probability of a crisis by about 0.1 percentage points. For a country with a current account deficit of 10% of GDP (the size of the current account deficit in many countries of the Eurozone periphery prior to the recent crisis), a 1 percentage point increase in credit growth increases the probability of a crisis by about 0.5 percentage points.